VZCZCXRO1912
RR RUEHAG RUEHAST RUEHDA RUEHDF RUEHFL RUEHIK RUEHKW RUEHLA RUEHLN
RUEHLZ RUEHPOD RUEHROV RUEHSR RUEHVK RUEHYG
DE RUEHBW #0708/01 2001749
ZNR UUUUU ZZH
R 181749Z JUL 08 ZDK
FM AMEMBASSY BELGRADE
TO RUEHC/SECSTATE WASHDC 0172
INFO RUEBAAA/DEPT OF ENERGY WASHINGTON DC
RUCPDOC/USDOC WASHDC
RUEHZL/EUROPEAN POLITICAL COLLECTIVE

UNCLAS SECTION 01 OF 02 BELGRADE 000708

SIPDIS
USDOC FOR 4232/ITA/MAC/EUR/OEERIS/SSAVICH

E.O. 12958: N/A
TAGS: ECON EINVETRD SR MW
SUBJECT: Serbia: Inflation Challenges Ahead for the New Government

BELGRADE 00000708 001.2 OF 002

Summary

¶1. Despite continued strong GDP growth of 8.2% in the first quarter 2008, the new government will face serious economic challenges. The immediate challenge will be reducing the estimated $700 million 2008 budget gap in the face of expensive campaign and coalition promises. Medium term challenges include suppressing annual inflation that reached 12.1% in June and decreasing the current account deficit. Long term stability can be achieved only with painful public sector reform and controlling public expenditure growth. Economists question the new government's resolve. End Summary.

Immediate Challenge: 2008 Budget Gap of $700 Million
-- -------

¶2. Despite continuing strong GDP growth of 8.2% in the first quarter 2008, mostly driven by domestic demand and service sector growth, the new government will face serious economic challenges. The immediate challenge will be closing the 2008 budget gap of $700 million that is expected in the second half of the year due to lower privatization revenues. Political uncertainty contributed to the failure of the recent large privatizations of mining firm RTB Bor, Genex Kopaonik's tourist properties, and tractor manufacturer IMT, and delayed other planned privatizations. As a result, Prime Minister Cvetkovic announced the government would issue $600 million in bonds to cover the deficit, most likely in September.

Stamenkovic: Budget Gap Much Wider

¶3. Stojan Stamenkovic of the Economic Institute publicly estimated that the budget gap would be much wider since pensions alone are headed for an $800 million deficit in 2008 due to the promised 10% pension increase. In addition, the Pension Fund is receiving lower than expected direct revenues and the inflation adjustment, originally planned for 8% in 2008, will likely reach 11%.

Despite The Gap, PM Announces Pensions Increase
-- --

¶4. In his opening remarks to parliament, Prime Minister Cvetkovic announced an increase in pensions from the current level of 55% of the average wage to "up to the maximum level of 70% in accordance with economic and fiscal capacities of the country." Economists agree that this is not sustainable and is higher than in any other transitional country. Rough estimates show that this increase would cost $1.3 billion in 2009. On the other hand, DPM and Economy and Regional Development Minister Dinkic announced a cut in the wage tax from 12 to 10% and an increase in non-taxable wage level. Dinkic also announced a goal to speed up privatizations in an effort to fill the budget gap with additional privatization revenues.

Medium Term Challenge: Inflation Suppression

¶5. The new government will have to deal with growing internal and external imbalances -- inflation and the current account deficit. Overall annual inflation reached 12.1% in June 2008, while core inflation which excludes state controlled prices reached 10%, far above the National Bank of Serbia (NBS) projected range of 3-6%. Inflation growth is due to external factors, including increased oil and food prices worldwide, but also from growing internal demand as a result of fiscal expansion and credit growth.

¶6. Although the NBS managed to curb credit growth from 39% in 2007 to 9% in the first quarter of 2008 via restrictive administrative measures in order to slow down personal consumption growth, public consumption remains high at 44% of GDP in 2007. The average net wage in May 2008 reached $643, in nominal terms up 19.1% over May 2007, but in real terms only 3% higher due to a 15.7% increase in the cost of living for the same period. NBS raised its benchmark interest rate from 10.75% in early January to 15.75% in May, but core inflation continued to rise.

Additional Challenge: Current Account Deficit

¶7. The current account deficit significantly widened from January to May 2008 to $3.63 billion (16% of GDP) and was up 66% compared to January-May 2007, mainly due to a record trade deficit that jumped 45% over the same period. In addition to an overvalued dinar that resulted in cheap imports and less competitive exports, the deficit grew due to the lack of competitive domestic production. The new government will need to stimulate investment to increase the competitiveness of domestic production and exports.

Reserves Decrease

¶8. Serbia's balance of payments deteriorated in the second quarter of 2008 because of a reversal in a nearly steady increase in reserves over the last eight years in its foreign exchange reserves. From January to May 2008 reserves fell by $555 million. This was largely due to a shift in portfolio investments from an inflow of $562 million in January-May 2007, to an outflow in January-May 2008 of $95 million. Serbia's foreign exchange reserves were $15.45 billion on May 31, 2008.

Long Term Solution: Public Sector Reform

¶9. Stamenkovic highlighted public sector reform as the biggest challenge for the new government. Inflation was driven by structural problems linked to public sector and state consumption and the solution is public sector reform. He said reform should include: corporatization and privatization of public companies; reform of land policies - especially city land; reform of public expenditures including cancelling public company subsidies and transfers to social insurance funds and including rationalization and modernization of public services; decreasing the number of employees in the administration; etc. According to Miladin Kovacevic, Deputy Director of Statistics, growing imbalances would lead to rapid inflation growth within two years without serious reform.

Comment

¶10. Finance Minister Dragutinovic will face significant challenges in containing government spending in an environment where pork-barrel spending remains the rule rather than the exception. As a former NBS Vice-Governor Dragutinovic understands the hard work needed on the fiscal side to fight inflation and bolster macroeconomic stability, but many analysts doubt the government is prepared to take the necessary, but painful and unpopular actions. The Belgrade Stock Exchange has showed little optimism for the new government and has continued to fall since the government's formation. There is a possibility that this government may

ultimately deliver economic results in order to build a larger coalition majority in the next elections, which could be up to four years away. However, in the shorter term, the economic pressures of fulfilling the government's expensive campaign and coalition promises, such as increasing pensions, may threaten the fiscal prudence needed to keep inflation under control. End Comment.

BRUSH